India: Why it's getting tough for the RBI

The Reserve Bank of India has a difficult balancing act

6% India repurchase rate

25bp cut in August

India Central Bank meets on October 4th

There is unanimous consensus, including from ING, that the Reserve Bank of India won't be changing its monetary policy at its meeting this week. The RBI eased with a 25bp cut to the main policy rates, the repurchase rate to 6% and reverse repo rate to 5.75% at the last meeting on August 2, citing a downward inflation trajectory. We believe the central bank will allow sufficient time for the last rate cut to sink in before pondering the next move, although that was merely a reversal of tightening in April via a 25bp hike in the reverse repo rate (there was no change to the repo rate) as part of the RBI's liquidity management strategy without altering the neutral bias. As such the August cut is unlikely to provide the required impetus to the economy.

What's changed since the August cut?

Three data points stand out. First, and that came within few days of the rate cut, was a spike in CPI inflation (to 2.4% for July from 1.5% in the previous month). Second, which came within weeks, was a dismal 1QFY18 (April-June, 2017) GDP report showing a three-year low in growth of 5.7% YoY (6.1% in the previous quarter). With growth and inflation moving in undesirable and opposite directions, there seems no way for the RBI to go but to stay pat this week. The third and the most significant development are signals of overshoot in the FY2018 fiscal deficit above the 3.2% of GDP target as the government considers halting the downtrend in growth.

GDP growth slowed for the fourth consecutive quarter, of which the last two appear to be the demonetisation bites. Now over 10 months after demonetisation in November 2016, M3 and bank lending growth remain well below pre-demonetisation levels, a sign of tight liquidity conditions are hurting businesses.

> *Adding to the RBI's balancing act is increased tightening rhetoric by developed market central banks.*

With the US Fed and the European Central Bank setting their eyes on unwinding QE, it will become hard for the RBI to buck the global trend and ease further. We also believe 1.5% in June was the cycle low in CPI inflation and expect the continued uptrend above 4%, the RBI policy target, over the rest of the FY2018. As things stand now, the RBI's 7.3% GDP growth forecast for FY2018 is at an asymmetric downside risk, and vice versa for its 4% inflation target. Unless the economic winds turn around positively in the next two quarters, we anticipate the RBI maintaining its neutral policy for a prolonged period, well through end-2018.

FX implications

The Indian rupee (INR) is still one of the darlings of the EM FX world. It's sold off sharply against the dollar in recent weeks and while this is largely a US story, stemming from a positive reassessment of Fed tightening and Trump tax reform prospects, we acknowledge that short-term cyclical factors have turned negative for the currency. The rupee has been the weakest Asian currency in September – with the ≈2% depreciation in part fuelled by significant equity and bond portfolio outflows.

> *The disappointing 2Q GDP release may have tempered some of the "buy India" sentiment within the international investment community.*

INR support from the central bank and government policy has modestly waned. On the latter, concerns have been primarily over a short-term government stimulus package and a potential widening of India's fiscal deficit, which would be seen as a deterioration of the medium-term macro fundamentals. Such fears may be overblown in our view – and we continue to see the big picture for INR fundamentals as constructive. Fading this USD/INR move higher is our preferred tactic – with our view for a cyclical decline in the USD likely to see a move back towards the 64.00 level later this year.